



May 25, 1965

Letter 289

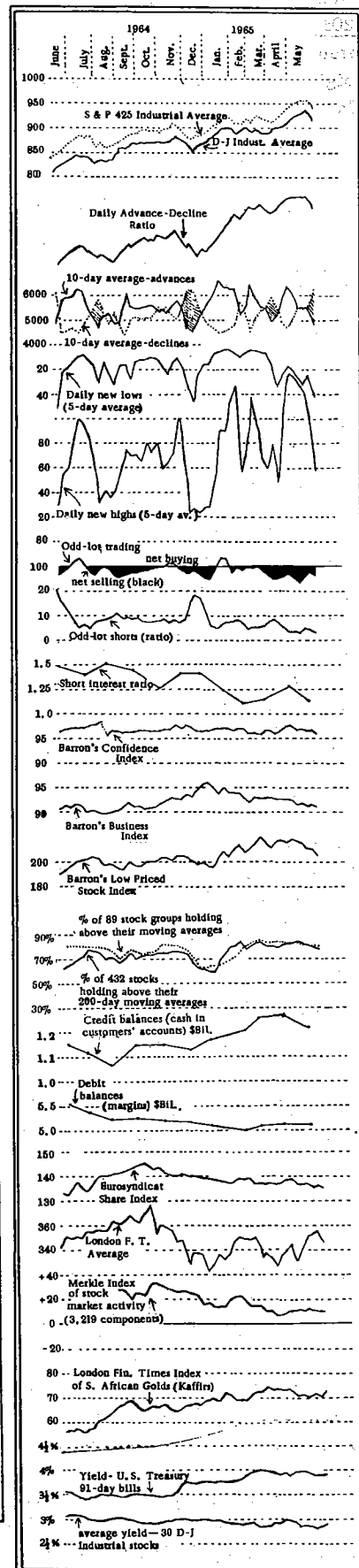
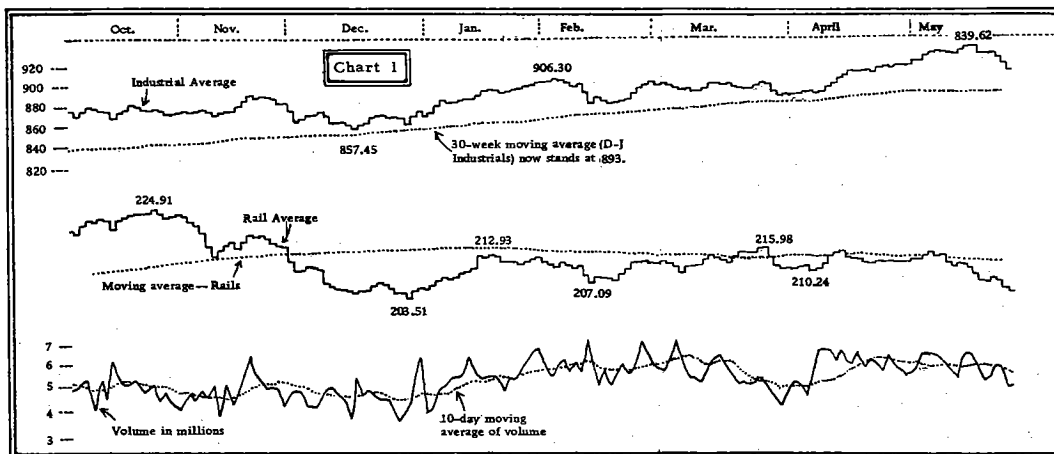
THE MARKET: For several months I have been directing attention to the extraordinary divergence which has developed in the two Averages. The Rail Average (study Chart 1) reached its bull market peak in October at 224.91. The November-December reaction took Rails to a low of 203.51. During the first five months of 1965, while the Industrial Average was pushing to successive all-time highs, the Rails merely worked sideways. In March the carriers generated hope by rallying to 215.98, thereby climbing just above their narrow 1965 range (but still well below their 1964 high). Unfortunately, the Rail strength was short-lived. Fresh weakness gripped the Rails last week, and on Friday (May 21) the carrier Average sank to a new low for the year (lowest level since the 203.51 mark of December, 1961 (see Chart 1).

What does all this mean? The situation was summed up particularly well in a letter just received from a veteran Dow Theorist, a man whom I have corresponded with for years: "Seldom have we had a nastier divergence. The Industrial Average needs no comment. The Rail sickness has been augmented, of course, by the revocation (I would call it) of the permission by the ICC for the merger of the Atlantic Coast Line and the Seaboard. (And this reminds me of the recent decision that two New York banks, actually merged for two years, should unscramble. What a madhouse!). In regard to the Rail Average, the fact remains that such independent cases as SX, SR, and GN have been flirting with the new-low list recently. The Rails have no further significant lows to penetrate but those of 207.09 (February) and 203.51 (December). If one looked at the Rail Average alone, the picture would be that of a potential major top."

(A.M.S., Phila., Penna.).

I will again stress that under Dow Theory the movements of a single Average (unconfirmed by the other) are meaningless for prediction purposes and very apt to be deceptive. As to the present situation, those in the bull camp maintain that despite the Rail weakness of the past seven months, Industrials continued to show resistance to the decline. Since the prevailing trend is taken to remain in force until proved otherwise, argue the bulls, it will only be a matter of time before Rails reverse their downward course and follow the Industrials to higher ground. The optimists also point to the position of the Industrial Average which is still approximately 28 points above its 200-day moving average (Chart 1) and 40 points above its February low of 881.88. This contrasts with the Rail Average which is below its own moving Average and also below the February low of 207.09. As yet, Industrials are far from confirming the Rail weakness (a down-side confirmation would entail an Industrial breaking of their own 881.88 February low).

Bears argue that the major divergence in the Average has now lasted for seven months. Judging by past records, this is a long time for the two Averages to be "out of gear." Such action, maintain the bears, has preceded many severe secondary reactions and many major bear markets. Furthermore, the divergence is the more significant because it has come following a two-year



Page 2 advance (from the 1962 lows) and because so much speculation (and high volume) has occurred within the area of divergence. Persistent divergence (or a series of non-confirmations), state the pessimists, following a long decline generally indicates a reversal to the upside. By the same token, persistent divergence (or non-confirmations) following a long rise usually indicates that a top is in the process of construction.

CONCLUSION: According to orthodox Dow Theory, the primary trend is conceded to remain intact until proved otherwise. The primary trend was last confirmed as bullish. The secondary lows recorded by both Averages in December remain the critical points (857.45 and 203.51). As long as one or both Averages hold above the December lows, the primary trend will be classified as bullish. The secondary trend is now obscure, and it would require a Rail advance above the March high of 215.98 and an Industrial push above the recent record high of 939.62 to turn the secondary trend clearly bullish. Last week the Averages traced out the first definitive downward zig-zag since last February; therefore the minor trend is designated as bearish.

PERSONAL OPINION: My own guess based on the total picture is that we are now witnessing the formation of a major top. I believe that the 224.91 Rail high of October, 1964, is probably going to stand as the ultimate Rail peak, although I cannot discount the possibility of a new Industrial high (perhaps during a coming "summer rally"). Nevertheless, I see this period as an opportune time for unloading all long-term holdings.

ADDITIONAL COMMENTS: In the last Letter I mentioned that the implications of volume remain constructive. Volume has tended to expand on rallies, and it has tended to contract on the most recent decline. It should be noted, however, that volume can be quite tricky (particularly at major turns), and two or three day's volume should never be taken as conclusive. Students should attempt to place volume implications within the framework of the larger picture, and the general trend of volume should be watched on successive rallies and declines. To make matters more difficult, I will add that the majority of major declines in the past have started on deceptively light volume, and volume on these declines did not expand importantly until the drop was almost half over. The phenomenon was seen (most recently) during 1957, 1960, and 1962.

Now that the Rails have shown persistent weakness, I have received the usual inundation of letters arguing that the carriers are "no longer an indication of the nation's traffic" and that we should add airlines or trucks or both to the Rail Average. I will not belabor the point except to say that (1) I still cannot conceive of an expansion in the nation's industry without it benefitting the rail stocks to some extent; (2) Dow's Theory does not require a new Rail high in each successive bull market. All we need in Dow Theory terms is successive reconfirmation by Rails, each high above the previous high. Conceding that rail-roading does not represent a dynamic industry, Rails are surely no worse (from a competitive standpoint) now than they were last March (at the 215.98 high). If this is so, then what excuse can we provide for the Rail's refusal to better their high of two months ago?

The Composite (Page 1) Chart is beginning to present a bearish bias. Last week saw the worst drop in the DJIA since the week of President Kennedy's assassination. The 10-day average of declines has now assumed the bearish position above advances. The new low index has expanded to an (inverted) high for the year. The short interest ratio has dropped to 1.13, slightly better than neutral. Barron's Confidence Index has refused for six months to register a new high (above the November 97.6 high). Barron's Low-Priced Stock Index has dropped to its lowest level since January. The London Stock Average has sunk below its recent 350 "breakout" point, perhaps on the shocking news that the cost-of-living in Britain jumped a ridiculous 2% in April, largest monthly rise in 10 years. The stock Averages of Austria, Belgium, Japan, Switzerland and Germany are now at or within fractions of their lows for 1965. The Kaffirs (S. African) gold index, going against the trend, has risen above 71 to its highest level since early April and within 3 points of its

WHAT I THINK: Following my discussion of Vietnam in Letter 287, many subscribers have written to ask "what I really think." I believe that history moves in tides, and that the tides sweep in the men. If you understand the nature of the tide and if you know the character of the leaders, then you have at least a chance to glimpse the future.

I have just finished reading "Mao Tse-tung, an Anthology of his Writings" (Mentor books in paperback, 75¢). I recommend this book to every subscriber because I believe in knowing what you are pitted against — regardless of whether the struggle involves business, love, politics or anything else. The 44 page introduction to the book is worth reading alone. It tells the story of Mao's life. Mao is tough, he is dedicated, he is single-minded and he believes history is on his side. In his battle for Communism Mao has lost his wife, his sister and his son. I suspect that Mao is rather typical of Chinese leadership. Mao is not going to compromise, he is not going to "ease up." To understand this is to understand what the U. S. faces today. I believe that Russia now understands the character of its implacable Chinese "brother-in-arms." This "understanding" is probably causing a lot of lost sleep in Moscow.

The Chinese Communists believe in the straight, old fashioned "world Communism" approach. They believe that Russia has "gone soft" or is actually in the process of defecting to the West (witness Russia's rapprochement with France). The Chinese see the Russian predicament as an opportunity for them. For the two prizes which China dreams about are India (with her gigantic population) and Africa (with her fabulous natural resources). One out of every four human beings in the world is now Chinese. If China can control India and Africa, she will control a great majority of the world's population (and a large chunk of her wealth).

China's ultimate goals are (1) to control Asia itself; (2) to foment revolution and Communist "take-overs" throughout the underdeveloped nations. If one believes that China is aiming in this direction, one must necessarily be uneasy about the future. That the Chinese are now pushing and probing in ever-widening areas can be seen in Vietnam, in Indonesia, in Africa and in Thailand.

From the current issue of Atlas (a magazine devoted to translating the world's press) I include a few flagrant (and typical) excerpts from a recent speech given at an Afro-Asian seminar by Non Han-chen, one of China's chief economic spokesmen. The speech advocated the seizing of Western-owned resources and industries by the underdeveloped nations. Atlas entitled the article: "Mao Declares Economic War."

"The Afro-Asian peoples have created tremendous wealth with their own hands, but unfortunately in the past few centuries they have become the object of the enslavement and exploitation by the imperialists and the old and new colonialists.... In order to free themselves completely from the control and plundering by imperialism, to radically change the deformed structure of national economy resulting from long years of past colonial rule, it is necessary for the Afro-Asian peoples to make full use of their national resources and gradually to achieve industrialization of their respective countries in accordance with their specific conditions.

"Asia and Africa have markets that are steadily expanding.... Once all these resources return to the hands of the broad masses of the peoples of the Afro-Asian countries, they will certainly constitute an inexhaustible source of strength for the future economic development of the Afro-Asian countries.

"Let us, Afro-Asian peoples and peoples of the world, unite even more closely. Let us persevere in struggle, defy difficulties, advance wave upon wave, carry the struggle against imperialism, especially against U. S. imperialism, to the end and thoroughly achieve the national liberation of the peoples of all Afro-Asian countries."

So there it is, and let's not make any mistake about it. This is not the sound of conciliation, peace, and a world working together. This is the sound of revolution, foment and possibly of war.

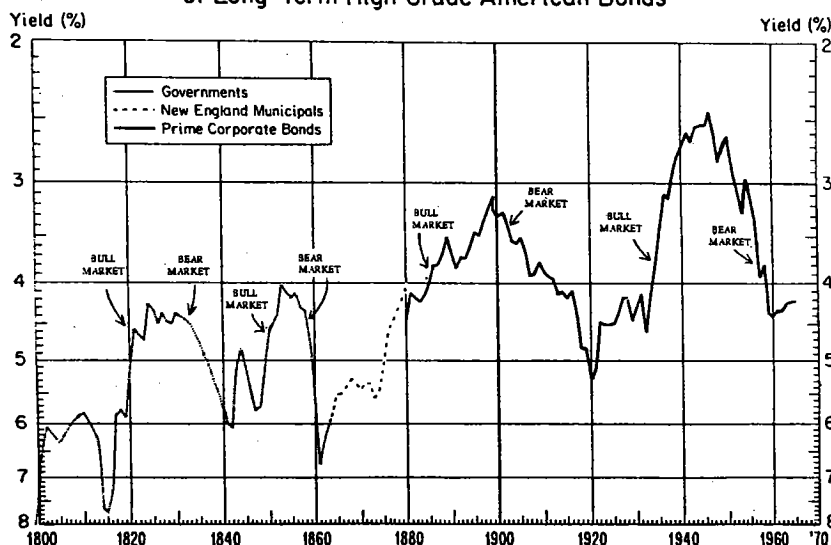
high for the year. **CONCLUSION:** Deterioration in the majority of the indicators is clearly visible, and this fits in with my previous opinion that the market is now in the process of forming a major top.

Inverted Yields of Long-Term High Grade American Bonds

BONDS: On May 5 President Johnson asked Congress for an additional \$750 million to cover the added cost of the next three months' expenses in Vietnam and the Dominican Republic (many believed this represented the President's method of obtaining "a vote of confidence" from Congress). Two weeks ago Mr. Johnson put forth his plan for a \$4 billion cut in excise taxes. The cut in government income in the face of increased (war) expenses would have drawn gasps of surprise (even horror) in another age. Today it is accepted with no more than a shrug ("more of the same"). But the new expenses and the new tax cuts once again focuses attention on the money market and the bond market (and it will no doubt ultimately focus attention on what promises to be a whopping rise in the U. S. balance-of-payments deficit).

The overall bond picture was last reviewed in Letter 258.

The major movements in the bond market are generally of great duration and extent; so great, in fact, that the average investor fails to recognize them as bull and bear markets. Nevertheless, the accompanying chart, covering 165 years of bond yield action, serves to document the thesis that the bond market is subject to major bull and bear swings. As a rule, the great movements in the bond market are much more sustained than those in the stock market. For instance, as seen on the chart, there have been only eight bull and bear markets in bonds since 1800. Furthermore, since 1900 there have been only three major movements; the first a 21-year bear market lasting from 1899 to 1920. That bear market ended with prime corporate bonds at an average yield of 5%. Next, a 26 year bull market (1920 to 1946) took bond yields to an average of approximately 2.5%. As an aside, few people realize that during 1929 to 1932 bonds were sustained by the prevailing bull market in bonds (despite the disastrous bear market in stocks). Had this not been the case, it is probable that the bond market during the early 1930's would have crumbled in utter chaos. Of great interest is the fact that during the 1920's the U. S. Government was actively moving to reduce the national debt, and between 1920 and 1929 the national debt actually decreased from \$23.7 billion to \$16.5 billion. During the war years of the early 1940's the Government "pegged" (supported) the Treasury bond market, and this of course placed an artificial floor under bonds.



In 1946 the pegs were removed, and the chart shows that the bond market has been in a major bear market ever since. Average corporate bond yields touched a high of almost 4.5% in 1960. Since then the U. S. Government has followed a "cheap money" policy while simultaneously flooding the market with new debt securities. For example, between 1960 and 1965 the amount of Treasury bills (maturities of one year or less) rocketed from \$33 billion to \$60 billion. Subscribers should remember that all classes of debt (private as well as public, mortgages as well as bonds) compete with each other. As an example of what is taking place, during the period of 1955 to 1963, combined public and private debt in the U. S. rose from \$672 billion to \$1,093 billion. This headlong plunge into debt is hardly the food from which bull markets in bonds are created.

The intangible ingredient which serves to hold together any mountain of debt (regardless of whether that debt belongs to Webb & Knapp or the U. S. Government) is always the same — confidence. Should something occur to impair the current atmosphere of confidence, it is this observer's opinion that debt instruments would plunge and interest rates would sky-rocket. Such action would undoubtedly go a long way towards "squeezing the water out" of the money market. It would also complete the bear market in bonds which began in 1946.

It is of particular interest to witness a bear market in bonds continuing in the face of the current wide-spread acceptance of the Government's role in managing the money markets. Never has there been such complacency regarding the ability of the Treasury and the Federal Reserve to control our money markets. Nevertheless, this "faith" in our money managers was shaken over the past year by DeGaulle (in his attack on our gold reserves) and by Jacques Rueff (in his attack on the whole gold-exchange system). When one's faith is attacked, the resultant end-product is anger. All of which explains the recent U. S. surge of anger directed at France, DeGaulle, Rueff, and any and all who dare to advocate hard money while helping themselves to our dwindling gold supply.

Many subscribers have written to ask what the possible effect of war would be on the markets. War results in the production of weapons. But weapons are not instruments of production, and war is therefore bearish in that it dissipates (actually destroys) capital. Wars are financed by great inflations in currency. Many governments and individuals, recognizing this fact, are prone to hoard gold during wars. Since wars (if they are large wars) usually bring about price controls, my own belief is that a major extension of the current U. S. — Vietnam struggle would be ultimately bearish for equities and bullish for gold shares. It would also be bearish for bonds in that huge new issues of debt would have to be placed on the money market.

GOLD FOLLOW-UP: As seen on the weekly chart, the dollar price of gold broke sharply during February to April. However, the price of gold did not drop below \$35.08 3/4 which is the "conversion price" of gold. In other words, it costs 8 3/4¢ to ship gold to London from the U. S. and presumably as long as the price of gold remains above the conversion price, the gold pool (50% owned by the U.S.) is losing gold. The continuing drain in gold showed most recently in the \$60 million loss of U.S. gold over the last month. A fascinating aside on the gold picture is the news that Red China has now joined Russia as an interested accumulator of gold. According to the New York Times, China has recently purchased over \$60 million of gold through the London Gold pool.

I continue to feel that subscribers may hold 10 to 15% of their assets in S. African gold stocks and the fact is that these stocks have held very well during the second quarter weakness. Although many technicians and speculators have "thrown in the sponge" on the golds, this writer does not agree. Often, price movements can be studied to best advantage on a long-term or monthly chart, and for this purpose I include a chart of Dome Mines, a leading Canadian producer (actually Dome is now a holding company with total assets now near \$50 per share). Dome has been climbing within a rising channel for the last seven years, and on the monthly chart the recent weakness hardly registers. It will take much more than the 1965 action so far in DM to make me believe that this stock has "topped out" from a long-term standpoint.

For American-South African Investment Trust, a stock I have recommended here many times, I have shown a point and figure chart. The X's on the chart indicate rallies, the O's denote declines. Here we note that ASA has continued to climb up a large ascending channel which has been in effect since the stock was first listed on the N.Y.S.E. Corrections during 1963 and 1964 touched the bottom of the channel, but the first 1965 correction (signalled by the first black square on chart) did not carry as far as the lower trendline. Following a rally to a new high, a second bearish signal was recently registered (second black square) when ASA touched 47. It is an interesting technical phenomenon that the second correction (so far) has halted at a second minor trendline as drawn on the chart. Last week ASA rallied back to 51. ASA would have to drop to 44 to scare me out of it. At 44 ASA would give a bearish signal and also would drop out of the three-year rising channel. So far it has not happened, and I would definitely continue to hold ASA with a stop-loss at 44.

HE WHO FIGHTS AND RUNS Industrials (this is written on Tuesday, May 25, after the opening) have dropped approximately 25 points in the past six trading sessions. This is admittedly a very steep drop. Many wonder if the market is not now "oversold" and ready for the inevitable 1/3 to 2/3 upward correction. Others speculate as to whether this is the beginning of a real bear market; they wonder whether they should not now sell most of all of their stocks. There is not a man alive who can provide the answer. All stocks, at this stage of the game, should have actual or mental stop-losses under them. Every trader and investor should have an actual or theoretical level below which he is not willing (at a profit or a loss) to carry a commitment.

Perhaps two-thirds of the stock market's lifetime is spent in bull moves. Thus, the odds are always against a bear market. By the same token, severe collapses are rare, and the odds are always against such a disaster occurring. Nevertheless, collapses do occur. When they do, they break many an investor and speculator. The rise in the Average since October, 1962, has been extraordinary in that it has not yet produced even a minimum one-third correction. Market history suggests that the most violent corrections and bear markets often stem from the longest and most persistent rises. The post-war bull market which began in June, 1949, has not yet been corrected by a major bear market. The advance since October, 1962, has not yet been subject to a full correction. These facts alone should suffice to eliminate any preconceived notions as to what may or may not happen during the period ahead.

STOCKS that hold on violent sell-offs often lead the next advance. Among stocks which impress me so far are Symington-Wayne (Letters 271 and 279), Phillips-Van Heusen (Letter 279), Ogden (Letter 285), National Distillers (Letter 286), Fansteel (Letter 287), Rohr (Letters 265 and 285) and Lowenstein (Letters 239 and 268).

Chart of ASA courtesy of Chartcraft, Inc., Larchmont, New York.

Chart of Dome courtesy of Securities Research Corp., 211 Congress Street, Boston, Mass. 02110.

Charts at right courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.

